

**CORPORATIONS COMMITTEE  
BUSINESS LAW SECTION  
THE STATE BAR OF CALIFORNIA  
180 HOWARD STREET  
SAN FRANCISCO, CA 94105-1639  
[www.calbar.org/2sec/3bus/2busndx.htm](http://www.calbar.org/2sec/3bus/2busndx.htm)**

June 17, 2003

Ms. Kathy Womack  
Office of Law and Legislation  
Department of Corporations  
1515 K Street  
Suite 200  
Sacramento, CA 95814-4052

Re: PRO 21/02

Dear Ms. Womack:

We are writing to provide comments on the proposal by the Department of Corporations (the “**Department**”) to adopt a new rule (the “**Proposed Rule**”) relating to the factors that may be considered by the Department in levying and assessing penalties under the California Corporate Securities Law of 1968, Corporations Code Section 25000 *et seq.* (the “**CSL**”). These comments are being made on behalf of the Corporations Committee (the “**Committee**”) of the Business Law Section of the State Bar of California (the “**Business Law Section**”). Please note that positions set forth in this letter are only those of the Committee. As such, they have not been adopted by either the State Bar's Board of Governors, its overall membership, or the overall membership of the Business Law Section, and are not to be construed as representing the position of the State Bar of California. The Committee is composed of attorneys regularly advising California corporations and out-of-state corporations transacting business in California.

**Membership in the Business Law Section, and on the Committee, is voluntary and funding for activities of them, including all legislative activities, is obtained entirely from voluntary sources. There are currently more than 9,500 members of the Business Law Section.**

**1. Background.**

Corporations Code Section 25252 provides that the Commissioner of Corporations (the “**Commissioner**”) may, after notice and opportunity for hearing, by order levy administrative penalties on any person subject to Part 3, Division 1 of Title 4 of the

California Corporations Code.<sup>1</sup> Part 3, Corporations Code Sections 25200-25255, relates to the regulation and notice filing requirements of agents, broker-dealers, investment adviser representatives and investment advisers. The statute provides that the maximum amount of the penalties shall be \$1,000 for the first violation and \$2,500 for each subsequent violation. However, these amounts are increased if the defendant is a broker-dealer or investment adviser. In either such case, the maximum penalty is \$5,000 for the first violation, \$10,000 for the second violation, and \$15,000 for each subsequent violation. Administrative penalties may only be assessed if the person *willfully* violates any provision of the CSL or any rule or order adopted or issued under the CSL. Administrative penalties are collected by the Commissioner and paid into the State Corporations Fund.<sup>2</sup> In this regard, the Committee notes that Corporations Code Section 25254 authorizes the Commissioner to include in any administrative action brought under Part 3, a claim for (i) restitution; (ii) disgorgement; or (iii) damages. The administrative penalties available to the Commissioner are not exclusive and may be sought and employed in any combination with civil, criminal, and any other administrative remedies deemed advisable by the Commissioner to enforce the CSL.<sup>3</sup>

Although the Proposed Rule relates solely to the levy of administrative penalties under Corporations Code Section 25252, the Committee notes that other provisions of the CSL provide for the imposition of civil penalties.<sup>4</sup> Corporations Code Section 25535 provides that any person who violates *any* provision of the CSL or any rule or order under the CSL shall be liable for a civil penalty not to exceed \$25,000 for each violation. There are several key differences between administrative penalties under Corporations Code Section 25252 and civil penalties under Section 25535:

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<sup>1</sup> Corporations Code Section 25252 provides:

The commissioner may, after appropriate notice and opportunity for hearing, by order levy administrative penalties as follows:

- (a) Any person subject to this part, other than a broker-dealer or investment adviser, who willfully violates any provision of this division, or who willfully violates any rule or order adopted or issued pursuant to this division, is liable for administrative penalties of not more than one thousand dollars (\$1,000) for the first violation, and not more than two thousand five hundred dollars (\$2,500) for each subsequent violation.
- (b) Any broker-dealer or investment adviser that willfully violates any provision of this division to which it is subject, or that willfully violates any rule or order adopted or issued pursuant to this division and to which it is subject, is liable for administrative penalties of not more than five thousand dollars (\$5,000) for the first violation, not more than ten thousand dollars (\$10,000) for the second violation, and not more than fifteen thousand dollars (\$15,000) for each subsequent violation.
- (c) The administrative penalties shall be collected by the commissioner and paid into the State Corporations Fund.
- (d) The administrative penalties available to the commissioner pursuant to this section are not exclusive, and may be sought and employed in any combination with civil, criminal, and other administrative remedies deemed advisable by the commissioner to enforce the provisions of this division.

<sup>2</sup> The State Corporations Fund is created by Government Code Section 13978.6(b) for the support of the Department of Corporations.

<sup>3</sup> Cal. Corp. Code Sections 25255 and 25252(d).

<sup>4</sup> In accordance with Government Code Section 11346.5(a)(2), the Department has listed Corporations Code Section 25252 as the reference that is being implemented, interpreted or made specific. Further, the Department's Initial Statement of Reasons refers only to administrative penalties under Corporations Code Section 25252.

- Administrative penalties under Section 25252 may be imposed only on persons subject to Part 3, Division 1, Title 4 of the Corporations Code while civil penalties under Section 25535 may be imposed on “any person”.
- Section 25252 refers to persons who “willfully violate” while Section 25535 does not include “willfully”.<sup>5</sup>
- The Commissioner levies administrative penalties under Section 25252 while a court orders civil penalties.

As with administrative penalties levied under Corporations Code Section 25252, civil penalties assessed under Section 25535 are not exclusive.

In addition to the foregoing civil penalties, the CSL provides for substantial criminal monetary penalties pursuant to Corporations Code Section 25540. The Committee further notes that a bill, AB 1031 (Correa), has been introduced that would establish a criminal fine of not more than \$25,000,000 for “issuers” (as defined in the Sarbanes-Oxley Act of 2002) that willfully violate Sections 25400 – 25402 of the Corporations Code.<sup>6</sup> The bill would also increase to \$25 million the criminal penalty for such issuers that violate Corporations Code Section 25541 relating to criminal fraud or deceit.

The Commissioner has proposed certain, non-exclusive factors that he may consider in determining the amount of penalties. Pursuant to Corporations Code Section 25215, the Commissioner is required to provide to a respondent notice of any order under Corporations Code Section 25252 and “the reasons therefor”. The Committee further believes that the Commissioner is required to make available to a respondent a copy of its procedures, including any procedures for the determination of penalties, pursuant to the Administrative Adjudication “Bill of Rights” under the California Administrative Procedure Act, Government Code Sections 11340 *et seq.* (the “APA”).<sup>7</sup> The Committee believes to the extent that the Commissioner has established factors of general application, they must be adopted as regulations in accordance with the rulemaking provisions of the APA and the regulations adopted by the Office of Administrative Law thereunder.

The Committee strongly believes that any determination of the criteria for the imposition of an administrative penalty should take into account the unique

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<sup>5</sup> Noting the obvious constitutional due process issues associated with Corporations Code Section 25535, one leading treatise has paraphrased the section as follows: “Any person who [in the most innocent and inadvertent fashion] violates any provision of this division shall be liable for a civil penalty [in an amount to be arbitrarily determined by the Commissioner of Corporations (or the court) but] not to exceed twenty-five thousand dollars (\$25,000) for each violation.” H. MARSH, JR. & R. ROY FINKLE, PRACTICE UNDER THE CALIFORNIA SECURITIES LAWS, §14.06B (2002).

<sup>6</sup> Pub. L. No. 107-204. The Committee presumes that the Department is the sponsor of AB 1031 (Correa).

<sup>7</sup> Cal. Gov. Code Section 11425.10(a)(2).

procedural aspects and the special responsibilities of the Commissioner in making the determination of penalties. Unlike civil penalties under Corporations Code Section 25535, a court does not determine the amount of the penalty. Rather, the Commissioner levies penalties with an opportunity for a hearing. Corporations Code Section 25215 provides that if a respondent timely requests a hearing, it must be conducted in accordance with the formal hearing procedures set forth in Chapter 5 of the APA. While the APA requires separation within the Department of the prosecutorial and adjudicative functions, this does not afford the full measure of due process afforded to persons when the adjudicative function is lodged within a separate and co-equal branch of the government.<sup>8</sup> This is particularly apparent in light of the fact that the administrative law judge hearing a case does not issue a final decision. Rather, the administrative law judge prepares a proposed decision that may be adopted or rejected by the Commissioner.<sup>9</sup> Thus, the Commissioner is ultimately responsible for determining the outcome of a proposed case that has been initiated by the Department's enforcement staff.

**2. The Commissioner's rules should be based upon specific goals that are publicly disclosed.**

The Department's Initial Statement of Reasons has identified one reason for establishing specific goals – *i.e.*, to help ensure that penalties are not assessed in an “arbitrary and capricious manner”. While the Committee believes that this is an important justification for adoption of the Proposed Rule, the Committee believes that this is not the only heuristic principle that should guide the determination of penalties under the CSL. The Committee believes that the Commissioner should consider *all* of the following purposes in establishing factors for the levying of penalties.

- **Transparency.** The public, the respondent, and the Department should clearly understand the reasons for any assessment of penalties.
- **Consistency.** Due process requires that like cases be treated alike.<sup>10</sup>
- **Deterrence.** The imposition of penalties can serve the purpose of both individual and general deterrence.
- **Retribution.** Independent of any deterrent effect, the public in general, and the victims in particular, may require that the respondent be punished.
- **Accountability.** Criteria for the determination of penalties can increase the accountability of the Commissioner to the public for his or her enforcement decisions.

The Committee believes that the efficacy of the proposed factors as well as any proposed additional factors should be evaluated in light of the above five purposes.

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<sup>8</sup> Cal. Gov. Code Section 11425.10(a)(4).

<sup>9</sup> Cal. Gov. Code Section 11517(c)(2).

<sup>10</sup> U.S. Const. Amend. XIV, § 6 and Cal. Const., art. I, § 7(a).

Accordingly, the Committee recommends that the Proposed Rule expressly acknowledge all of the foregoing purposes. (A revised Proposed Rule is attached to this letter)

**3. The Proposed Rule and Statement of Reasons should clarify that it applies to administrative penalties levied against persons, including broker-dealers and investment advisers, subject to Part 3, Division 1, Title 4 of the Corporations Code.**

The Initial Statement of Reasons and the Proposed Rule state that the criteria are to be used in determining the amount of any administrative penalty levied against “any person”. Corporations Code Section 25252, however, does not authorize the levy of penalties against any person who violates a provision of the CSL or a rule thereunder – rather, it authorizes imposition of penalties on any person “subject to this part” (*i.e.*, Part 3, Division 1, Title 4 of the Corporations Code). Accordingly, the Committee recommends that the Final Statement of Reasons and the Proposed Regulation clarify that the standards apply only to persons subject to Part 3, Division 1, Title 4 of the Corporations Code.

The Committee notes that AB 1031 was recently amended to provide that administrative penalties may be levied by the Commissioner on all persons whether or not they are subject to Part 3, Division 1, Title 4 of the Corporations Code. Because this amendment was furnished by the Department after the notice of proposed rulemaking, the Committee is not commenting at this time on either AB 1031 or the effect of AB 1031 on the proposed rule.

**4. The Proposed Rule should take into account the limited due process afforded when administrative penalties are levied.**

As discussed above, the Department effectively sits as investigator, prosecutor and adjudicator when administrative penalties are levied pursuant to Corporations Code Section 25252. The Commissioner’s fundamental responsibility is to do justice. The purpose of assessing penalties should not be to maximize revenues to the State Corporations Fund or to obtain publicity for the Department. The Commissioner should recognize that in levying administrative penalties, the Commissioner is not acting as counsel to victims but for the interests of the public at large. Penalties should be specifically related to the particular law and facts of the case. Violations not included in the accusation should never be used as the basis for determining penalties. Large penalties should not be proposed in an effort to intimidate respondents into settlements with the Department.

**5. The Proposed Rule should clearly establish mitigating and extenuating factors.**

Consonant with the Commissioner's special responsibility to do justice, the Committee believes that the Commissioner should consider all factors tending to mitigate or extenuate the culpability of the respondent. Mitigating factors are those that reduce the respondent's moral culpability for a violation, while extenuating evidence renders a violation less aggravated or reprehensible. By establishing mitigating and extenuating factors, the Department can enhance the transparency and accountability of its decision making. These criteria will also assist the Commissioner in establishing a just result.

**6. The Proposed Rules should clearly establish enhancing factors.**

The Committee also believes that justice is best served by the clear establishment of enhancing factors (*i.e.*, those factors that increase the moral culpability of the respondent). Societal interests in deterrence and retribution will not be adequately met unless appropriate penalties are seen to have been imposed. While the Proposed Rule lists several factors that justify the enhancement of a penalty, the Committee believes that several additional factors should be included.

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The Committee commends the Commissioner for proposing to adopt a regulation that establishes the criteria for the imposition of penalties under Corporations Code Section 25252. The Committee believes that the adoption of criteria will improve the consistency, transparency and accountability of the Commissioner's decision making. The Committee further believes societal interests in deterrence and retribution are also served when mitigating, extenuating and enhancing factors are clearly enunciated by the Commissioner.

Keith Paul Bishop  
Co-Chair

Bruce Dravis  
Co-Chair

Ms. Kathy Womack

June 17, 2003

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**The State Bar of California Business Law Section  
Corporations Committee Members**

As of the date of this letter, the Corporations Committee is composed of the members shown below, not all of whom necessarily endorse each and every recommendation and view expressed in this letter. Taken as a whole, however, this letter reflects a consensus of the members of the Corporations Committee.

Curt C. Barwick  
Keith Paul Bishop, Co-Chair  
John C. Carpenter  
Nelson D. Crandall  
Bruce Dravis, Co-Chair  
James K. Dyer, Secretary  
Teri Shugart Erickson  
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Stewart Laughlin McDowell  
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Daniel J. Weiser  
Neil J Wertlieb  
Nancy Wojtas, Vice-Chair, Legislation  
Brian M. Wong

Administrative Penalties

The Commissioner has established the following criteria to be applied in determining the amount of any administrative penalty to be levied pursuant to Section 25252 of the Corporations Code.

- (a) In determining the amount of any penalty, the Commissioner shall consider the following:
- (i) The goal of full transparency, i.e., the basis for the any penalty should be clearly communicated so that it is clearly understood by the public, the respondent and the Department;
  - (ii) The principle that similar cases should be treated similarly;
  - (iii) The deterrent effects, both general and specific, of any penalty;
  - (iv) The retributive effects of any penalty; and
  - (v) The promotion of the public accountability of the Commissioner with respect to determinations of administrative penalties.

All penalties must be proposed in light of the specific facts and circumstances of the case and the violations actually alleged. Large penalties shall not be proposed in an effort to encourage settlement.

- (b) The Commissioner shall consider the following mitigating and extenuating factors:
- (i) In all cases:
    - i. Whether the alleged violation was voluntarily reported to the Department
    - ii. The extent to which the respondent has undertaken remedial action, including restitution or payment of damages
    - iii. Whether the violation involves a statute, rule or order not previously enforced by the Department
    - iv. Whether the violation involves an interpretation of a statute, rule or order not formally adopted as a rule under the Administrative Procedure Act or otherwise publicly announced by the Department prior to the violation
  - (ii) In the case of an individual:
    - i. Age
    - ii. Education
    - iii. Mental and emotional condition



- iv. Employment history
  - v. The Financial condition of the respondent, including net worth, net income and the effects of any penalty on the respondent's ability to pay damages, make restitution, meet child or spousal support obligations, or make payments to creditors
  - vi. Family and community ties
  - vii. Military or public service
  - viii. Charitable works
  - ix. The absence of any personal financial gain by the respondent in connection with the violation.
- (iii) In the case of any person that is not an individual:
- i. The financial condition of the respondent, including its net worth and net income, including the effects of any penalty on the respondent's ability to pay damages, make restitution, or make payments to creditors
  - ii. The respondent's establishment of compliance procedures and standards
  - iii. The degree of communication of compliance procedures and standards within the organization
  - iv. The degree of oversight exercised by the board of directors (or other governing body) and officers or managers of the respondent
- (c) The Commissioner shall consider the following enhancing factors:
- i. Amount of financial loss caused by the violation
  - ii. The number, nature and degree of seriousness of the respondent's prior, final administrative, civil or criminal orders, penalties, fines, judgments or convictions
  - iii. The degree of harm caused by the respondent's conduct, including whether the violation caused the insolvency of any person
  - iv. The number of victims
  - v. Whether violation involved vulnerable victims (i.e., persons not reasonably able to protect their interests)

The good faith assertion of any defense or privilege, however, shall not be used as an enhancing factor.